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SUBJECT: TFH01: PRIORITY ECONOMIC TASKS FOR UNITY  
GOVERNMENT OF HONDURAS

REF: TEGUCIGALPA 903

11. (SBU) Summary: If the negotiations now underway between representatives of President Manuel "Mel" Zelaya and the Micheletti regime lead to a political settlement, a new unity cabinet will be appointed to lead the government through the November elections until a new administration takes over January 27. The unity government will have pressing economic and financial issues to address. These issues include reordering public finance, closing the budget gap, restarting stalled projects and improving tax collection and helping to improve the investment climate. Successful implementation on these fronts is essential in order to facilitate a smooth transition from the unity government to the new government to be elected in November and taking power on January 27, 2010. Assuming the new government achieves international recognition, the international community needs to be prepared to provide resources (technical assistance and funding) to assist it. End Summary.

12. (SBU) With representatives of the Zelaya government and the Micheletti regime engaged in face-to-face discussions, a negotiated settlement may be close at hand. If a political agreement is announced, international donors will have to move quickly in developing a technical assistance program to address the daunting economic and financial challenges the unity government will face. Following is a discussion of these challenges and what we and other donors can do to help address them.

#### Public Finance

13. (SBU) A first step would be announcing the intention to recognize all sovereign debts incurred under both the Zelaya government and the de facto regime. This will calm markets and allow the unity government to continue issuing bonds to finance the budget deficit and to contract with multilateral and bilateral lenders.

14. (SBU) Public finance was restructured under the de facto regime, which should give the unity government breathing space to develop a transitional financing plan (ref A). The Zelaya administration borrowed with no clear purpose (e.g.

through Venezuelan President Hugo Chavez's PetroCaribe and ALBA initiatives). Its domestic debt issuance lacked a coherent rationale, serving both to fund government and to control interest rates; this caused a great deal of confusion among investors. The de facto regime restructured a short term loan from the Central Bank (about USD 200 million) to ten years, issued three-year bonds to the banking system after Central Bank changed its rate of required investments (see Monetary Policy below), and was rolling over maturing debt (approximately USD 200 million). The unity government would need to continue these efforts and also look to restructuring maturities falling due early in 2010 (about USD 150 million) to relieve pressure on the newly elected incoming government.

#### Finance Budget Gap

15. (SBU) Although the Zelaya government projected a fiscal deficit of 2.4% of GDP, the de facto regime increased this forecast to 4.2%, primarily due to a drastic decline in tax revenue resulting from the international financial crisis and domestic political unrest (pre and post coup). However, this increased budget gap projection may still be too low, since it relies on two optimistic assumptions: 1) that the international community will continue to provide project funding and budget support at previous levels, and 2) that the protracted political crisis will not unduly harm business activity. The unity financial team will need to address the possibility that the budget gap will be larger than forecast and to develop mechanisms to address this possibility. The team will also need to work with the international community

to restart stalled projects and to make sure that budget support funds are available.

#### Monetary Policy

16. (SBU) The monetary policy of the Zelaya administration was to inject liquidity into the banking system and force down interest rates in the hope that this would spur economic growth despite the international financial crisis. The policy, however, upset the banks and did not lead to an increase in lending. (Comment: Systemic deleveraging is a worldwide phenomenon and not specific to Honduras. End comment.) The de facto regime changed the focus of monetary policy to providing stability to the banking system by allowing interest rates to rise and sopping up some of the idle excess liquidity by increasing the amount of investments that can be used as reserves at the Central Bank; this has eased some of the concerns of the banks. The unity financial team could continue this policy in order to give the next administration a stable financial system that will be able to support the policy decisions of the new government.

#### Exchange Rate Policy

17. (SBU) Neither the Zelaya administration nor the Micheletti regime has been inclined to modify the fixed exchange rate policy started in 2005 during the Maduro administration. This policy has outlived its usefulness and the unity financial team should be encouraged to take steps to liberalize the exchange rate as a means to spur export activity. This will have little impact on prices, as deflationary conditions prevail worldwide. It will also eliminate one of the main stumbling blocks to reaching an agreement with the International Monetary Fund (IMF), which has maintained that the Lempira is overvalued.

#### 2009 Budget

18. (SBU) After the Zelaya government failed to pass a 2009 budget, the de facto regime passed a budget in July. Given the short amount of time remaining in the fiscal year (less than three months), it would not make sense for the unity

government to prepare a new 2009 budget. Since the diversion of funds was a hallmark of the Zelaya administration, the unity government should name a budgetary oversight committee encompassing representatives of Zelaya supporters, de facto regime supporters, the political parties and possibly others. The work of this committee could be supported by technical assistance from the international community.

#### Tax Collection

¶9. (SBU) There will not be sufficient time for an increase in tax rates or levying of new taxes to generate funds during the mandate of the unity government. Furthermore, a tax increase could delay the possibility of an economic recovery in the short term. The focus of tax administration should be on enforcement of existing regulations and increasing tax compliance. The U.S. Treasury through its Office of Technical Assistance can help the unity government in achieving improved tax compliance by restarting a number of projects that have been stalled during the political crisis.

#### Unity Financial Team

¶10. (SBU) The reappointment of either President Zelaya's or Micheletti's financial teams to a unity government would create problems. Minister of Finance Rebeca Santos and Central Bank President Edwin Araque were ineffective in mitigating the profligacy of the Zelaya administration. Their replacements by the de facto regime (Gabriela Nunez and

Sandra de Midence, respectively) have done a credible job in strictly macroeconomic terms, but Nunez in particular has played a high-profile political role, and the two may be too controversial to fit into a unity government. Nevertheless, there remain a number of experienced technocrats that should be able to fill these posts.

#### Emergency Response Team

¶11. (SBU) The urgency of the problems facing the unity government will require the ability of the international community to respond quickly to the needs of the unity government. The international community should name an Emergency Response Team (made up of IMF, World Bank, U.S. Treasury, other diplomatic representatives, and others) that not only have technical expertise in government finance but also the ability to obtain resources from their governments and institutions.

#### Transition to the Next Administration

¶12. (SBU) The goal of these recommendations would be to provide the newly-elected legitimate government a solid base of public finance, a stable financial system, and the financial and technical resources necessary to implement its policies beginning at the end of January 2010. One of the Emergency Response Team's first steps should be to work with the unity government and the transition team of the next administration toward putting together an emergency stand-by arrangement and working toward reaching a new Poverty Reduction and Growth Facility (PRGF) agreement with the IMF. These lines of credit will reduce the exposure of the Honduran economy to exogenous variables such as environmental disasters, a double-dip recession in the U.S., etc. The Emergency Response Team can also work with the unity government and the transition team to develop a revised 2010-2014 budget and an indebtedness policy and debt strategy document for 2010-2014 which will give confidence to the international community and to investors regarding the future of Honduran finances.

#### Comment

¶13. (SBU) The recommendations contained in this cable are based on the presumption of a successful conclusion of the current negotiations between the representatives of the Zelaya government and the de facto regime and the installation of a unity cabinet composed of members of the Zelaya government, de facto officials, and others. There is a further presumption that the unity cabinet would take office well in advance of the installation of the newly elected government on January 27th. If the process of arriving at an internationally recognized government is different from these assumptions, the timing of some of the recommended actions may change, and the recommendations may apply to the new government rather than a unity government. Still, the challenges and recommended solutions will not change significantly, and the need for urgent action will remain. End comment.  
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